

# THE IMPACT OF PREFERENTIAL TRADE AGREEMENT ON FDI: EU – Canada Comprehensive Economic and Trade Agreement

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**Abstract**

In recent years the number of large Preferential Trade agreements (PTA), such as NAFTA, has been rapidly increasing. Facilitating and promoting Foreign Direct Investment (FDI) has been a central item in such trade agreements. Although, the prospect for attracting additional foreign investment is one of the main reasons to enter into a PTA, the expansion of PTAs is not followed up with expansion in foreign investments. This thesis assesses the potential foreign investment effects of the EU – Canada Comprehensive Economic and Trade agreement by analyzing relevant literature regarding the link between PTAs and FDI flows. The results indicate a potential increase in FDI flows in certain sectors, mostly resulting from FDI liberalization. A higher impact in Canada is more likely to result due to significantly higher restrictions on the FDI regulations than in the EU. Internal FDI distribution might change, especially in the EU, when exporting comes less costly within the integrated bloc and multinational corporations change production from one country to another. The overall effect is expected to be positive, however its significance is uncertain.

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**Keywords** Foreign Direct Investment, Preferential Trade Agreement, CETA, Investment Court System, FDI liberalization, FDI Regulation Restrictiveness Index

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## TABLE OF CONTENTS

<b>1. Introduction .....</b>	<b>3</b>
<b>2. Foreign Direct Investment.....</b>	<b>5</b>
<b>2.1. FDI determinants .....</b>	<b>5</b>
<b>3. Preferential Trade Agreement .....</b>	<b>7</b>
<b>3.1. Preferential Trade Agreements impact on FDI.....</b>	<b>8</b>
<b>3.2. Review of previous similar agreements.....</b>	<b>9</b>
3.2.1. North America Free Trade Agreement .....	10
3.2.2. Australia and the United States Free Trade Agreement.....	10
<b>4. EU and Canada Integration and Investment Environments .....</b>	<b>11</b>
<b>4.1 Current integration .....</b>	<b>12</b>
<b>4.2. FDI restriction types in EU and Canada.....</b>	<b>12</b>
<b>4.3. Comparison of the investment environments in the EU and Canada .....</b>	<b>13</b>
<b>5. Comprehensive Economic and Trade Agreement .....</b>	<b>16</b>
<b>5.1. CETA's impacts in a broad perspective.....</b>	<b>17</b>
5.1.1. Services and investment.....	17
5.1.2. Trade .....	20
5.1.3. Intellectual Property Rights .....	21
5.1.4. Labor mobility .....	22
5.1.5 Investor protection .....	23
<b>5.2. Potential positive effects of CETA based on the analysis of NAFTA and AUSFTA .....</b>	<b>25</b>
<b>6. Conclusion.....</b>	<b>26</b>
<b>References.....</b>	<b>28</b>

# 1. Introduction

In recent years facilitating and promoting Foreign Direct Investment (FDI) has been a central item in large trade agreements. Prospect for attracting foreign investment is generally recognized as one of the main reasons for entering Preferential Trade Agreements (PTA) (Medvedev, 2011). PTAs create a more integrated trade bloc, which in the short run, is expected to stimulate intra-regional trade and investment within the integrated bloc, and in the longer run, growth rates are expected to increase due to larger markets, tougher competition, more efficient resource allocation and various positive externalities (Blomström & Kokko, 1997).

Preferential Trade Agreements as a whole include number of provisions and guarantees which are important for attracting foreign investment. The provisions are not guaranteeing additional investment; however, are potential determinants for attracting FDI. Investment provisions target particularly facilitating foreign investments. In addition, FDI is often encouraged by 'national treatment' ensuring equal treatment for foreign and domestic investors. PTAs which grant higher protection for firm-specific assets - such as human capital and intellectual property - are more likely to gain investor confidence and attract foreign investment flows (WTO, 2011). Another critical requirement is allowing freer movement of corporate personnel, and including a dispute settlement mechanism and proper investor protection will further improve the investor confidence

After eight years of negotiations the European Union and Canada are signing the most ambitious agreement ever signed by the counterparts thus far. The Comprehensive Economic and Trade Agreement (CETA) is a trade agreement between the EU and Canada. By boosting trade, CETA is anticipated to create growth, jobs, and new market opportunities especially for small and medium sized companies. Removing nearly all custom duties CETA will lower prices and widen the choice for customers. Through various commitments made by the Parties CETA will create more opportunities for companies and make firms more competitive in EU and Canada. One of the main goals in CETA is to alleviate barriers to foreign investments and promote investments among Canada and EU.

This forward-looking analysis seeks to estimate CETA's potential impacts on FDI between the counterparts, as well as analyze the existing and possible obstacles complicating the FDI flow. The relationship between FDI and trade agreements is not straightforward and generally not well

understood (Blomström & Kokko, 1997; Chen, 2009; Medvedev, 2011). Generally, most studies suggest a positive relationship yet not a significant one. The channel how PTAs affect FDI incentives varies among the studies. Along with reducing FDI barriers, trade agreements have potential to affect foreign investments through diverse channels. Commitments made in areas such as trade, labor mobility, intellectual property rights, and investor protection mechanism have potential to attract foreign investment flows. However, some of these determinants can have two-way influences on FDI, and instead of increasing, FDI inflow might decrease.

A positive impact from CETA as a whole on FDI is expected, and it could be ‘notable’ but it is not likely to be significant. The magnitude will be different in Canada and the EU mostly due to differences in the level of FDI restrictions. Currently exceptionally high level of restrictions is making Canada a less competitive location for FDI. CETA has a significant potential to attract FDI in Canada by reducing and abolishing the restrictions. FDI inflow is likely to increase in certain sectors mostly due to liberalization of the ownership limitations. The internal FDI distribution can be expected to change, especially in the EU where member states are relatively heterogeneous.

Without any existing empirical research of the topic this analysis will rely on the relevant literature on Preferential Trade Agreements (PTA), such as North America Free Trade Agreement. To achieve a better understanding of the impact without empirical evidence it is necessary to examine determinants attracting FDI, similar free trade agreements, current relationship between the EU and Canada, and the content of CETA as well.

Due to page limitations, the following topics must be noted for narrowing the analysis. Firstly, both the European Union and Canada will be considered as a whole, not specifying any country or provincial differences or effects. Secondly, not only the EU and Canada will benefit from this agreement, but also third countries may encounter positive impacts. However, any positive or negative effect to third countries will be ignored, as well as their role as investors in the EU and Canada. The focus is only on the investment flows between the agreement parties. Lastly, United Kingdom is an important trade and investment partner for Canada. If and when UK’s prospective withdrawal from the European Union, Brexit, takes place it can have a retardant impact on the commissioning of CETA as well as the consequences of the agreement. Analyzing the impact of Brexit will be left outside of this thesis.

This thesis is divided into two parts. The first part will discuss i) Foreign Direct Investment and the motives for entering foreign investment, ii) Preferential Trade Agreements and the impact on FDI iii) previous PTAs and their impact on FDI. The second part focus is on CETA and it consists of i) overview of the bilateral economic relations of the EU and Canada, ii) current restrictions relating to FDI, iii) familiarization on CETA, and the potential impacts on FDI in Canada and the EU, and iv) the positive impacts on CETA based on the analysis of NAFTA and AUSFTA.

## **2. Foreign Direct Investment**

Foreign Direct Investment (FDI) is defined as a category of cross-border investments which involves long-term commitment in which an investor establishes a lasting interest in a foreign country and has a significant level of influence over a business (OECD, 2008). Ownership of 10% or more of the voting power is considered as direct investment and ownership of less than 10% is a portfolio investment. Generally, FDI is distributed into two categories; greenfield investments, and mergers and acquisitions (OECD, 2008). In greenfield investment, an entirely new company is established in the target country, whereas mergers and acquisitions mean complete or partial purchasing of an existing firm.

Many authors have attempted to address theory for explaining foreign investments however, no agreed general theory exists. Dunning (1993) created an eclectic paradigm (known also as OLI paradigm) which seeks to create a general framework for examining contextual specific theories of foreign direct investment and international production (as cited in UNCTAD, 1998). Eclectic paradigm, as the name implies, is a combination of alternative existing theories of FDI. The paradigm and motives for choosing particular FDI location are presented below.

### **2.1. FDI determinants**

Eclectic paradigm, by Dunning (1993), presents three commonly agreed sets of determinants which have to exist simultaneously for FDI to take place: ownership-specific advantages, locational advantages, and the presence of superior commercial benefits in an intra-firm as against an arm's-length relationship between investor and recipient (as cited in UNCTAD, 1998). The first stands for company's owned advantages e.g. proprietary technology or brand name recognition, which in the best-case scenario can compensate the costs rising in establishing new affiliates and production in a

foreign country. The second means the attractiveness of the host country determined by its advantages, such as low labor costs, functioning infrastructure, or large markets. Lastly, the third condition claims that the first and second determinants profit greater benefits through internalization. (UNCTAD, 1998)

According to Dunning & Lundan (2008) if only the first condition is met, companies rely on exports, licensing, or the sale of the patents over FDI. FDI comes more attractive if the second and third condition are added. In other words, none of these conditions develop FDI by themselves but when all conditions are in effect FDI becomes attractive. Whether and where companies decide to engage in FDI endeavors depends on sufficient country specific advantages which match the motives of the particular FDI (Feils & Rahman, 2008).

Motives for choosing the particular investment location can be categorized into market-seeking, efficiency seeking, and resource-seeking behavior (see Table 1) (Feils & Rahman, 2008). The goal for these strategies is, for example, to spread or reduce risks, pursue oligopolistic competition and match competitors' actions, or look for distinct sources of competitive advantage (OECD, 1998). Table 1 demonstrates the broad scale of potential determinants attracting FDI flow and presents the connection between FDI determinants.

Market size and market growth often attract market-seeking companies. Growing markets provide the ability to grow within the industry and achieve scale and scope economies (Kudina & Jakubiak, 2008). In addition, market-seeking FDI tends to appear in countries which have high trade barriers and cannot be accessed through other than FDI (Feils & Rahman, 2008). Whereas, resource-seeking companies will locate in countries where resources sought are abundant (e.g. natural resources or low labor costs). These resources are generally not available at home or are available at a lower price in foreign country.

Efficiency-seeking FDI comes into a country which has locational advantages which enable a company to compete in international markets and fully realize the internationalization benefits of the firm's assets (Feils & Rahman, 2008). There are two types of efficiency-seeking FDI. In the first, firms "take advantage of differences in the availability and relative cost of traditional factor endowments in different countries" (Dunning & Lundan, 2008). Whereas in the second case firms "take advantage of economies of scale and scope and of differences in consumer tastes and supply capabilities" (Dunning & Lundan, 2008).

**Table 1. Host country determinants of FDI**

Host country determinants	Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
<p>I. Policy framework for FDI</p> <ul style="list-style-type: none"> <li>• economic, political and social stability</li> <li>• rules regarding entry and operations</li> <li>• standards of treatment of foreign affiliates</li> <li>• policies on functioning and structure of markets (especially competition and M&amp;A policies)</li> <li>• international agreements on FDI</li> <li>• privatization policy</li> <li>• trade policy (tariffs and NTBs) and coherence of FDI and trade policies</li> <li>• tax policy</li> </ul> <p>II. Economic determinants</p> <p>III. Business facilitation</p> <ul style="list-style-type: none"> <li>• investment promotion (including image-building and investment-generating activities and investment-facilitation services)</li> <li>• investment incentives</li> <li>• hassle costs (related to corruption, administrative efficiency, etc.)</li> <li>• social amenities (bilingual schools, quality of life, etc.)</li> <li>• after-investment services</li> </ul>	<p><b>A. Market-seeking</b></p>	<ul style="list-style-type: none"> <li>• market size and per capita income</li> <li>• market growth</li> <li>• access to regional and global markets</li> <li>• country-specific consumer preferences</li> <li>• structure of markets</li> </ul>
	<p><b>B. Resource/asset-seeking</b></p>	<ul style="list-style-type: none"> <li>• raw materials</li> <li>• low-cost unskilled labour</li> <li>• skilled labour</li> <li>• technological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters</li> <li>• physical infrastructure (ports, roads, power, telecommunication)</li> </ul>
	<p><b>C. Efficiency-seeking</b></p>	<ul style="list-style-type: none"> <li>• cost of resources and assets listed under B, adjusted for productivity for labour resources</li> <li>• other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products</li> <li>• membership of a regional integration agreement conducive to the establishment of regional corporate networks</li> </ul>

Note: Host country determinants of FDI. Adapted from “World Investment Report 1998, Trends and determinants” by United Nations Conference on Trade and Development, 1998. p. 91

### 3. Preferential Trade Agreement

Preferential Trade Agreement (PTA), such as NAFTA, AUSFTA, and MERCOSUR are broad agreements with provisions on both trade in goods and services, and investments. Such agreements are established between two or more countries and allow preferential treatment for the counterparts. PTAs remove intraregional trade barriers among the members and contain FDI liberalization provisions to facilitate foreign investments. Consequences of liberalization will be that the host state amends or abolishes the laws prohibiting foreign investors from investing in its domestic market. In addition, PTAs contain relatively comprehensive set of foreign investment rules on what terms and to which sectors are investments welcomed.



This chapter is divided into two parts, the first will analyze Preferential Trade Agreements and the focus will be on whether establishing favorable low risk legal environment and guaranteeing equal and safe treatment for foreign investors will attract more FDI inflow. The second part analyzes FDI impacts occurred from previous PTAs. Two PTAs were chosen to be addressed: North America Free Trade Agreement (NAFTA) and Australia – United States Free Trade Agreement (AUSFTA).

### 3.1. Preferential Trade Agreements impact on FDI

In previous literature, the relationship between PTAs and FDI is generally not well understood. Most findings suggest a positive correlation however, the channel how PTAs affect FDI incentives differs (Medvedev, 2011). Medvedev (2011) conducted a research and results indicated that PTAs are associated with increases in FDI, however mostly driven by developing countries. As well as Büthe & Milner (2008) found positive causality between trade agreements and FDI, when analyzing the relationship of international political institutions, such as WTO and PTAs, and FDI inflow. The results showed that FDI flow was higher when the number of signed PTAs increased and interestingly Lederman et al. (2005) found correlation between FDI flow and the expectation of joining a PTA (as cited in Medvedev, 2011).

According to UNCTAD (2009) the removal of intraregional trade barriers is a simple explanation why PTA may stimulate FDI. Removing the barriers affects one of the main determinant of FDI – market size – as it creates larger regional market (UNCTAD, 2009). In contrast, Adams et al. (2003) found non-trade provisions to be the most important driver of FDI flow. Table 2 presents the results of Adams et al. (2003) research who studied the main drivers of investments in PTAs. Non-trade provisions, particularly those related to investments and services, were the most common attractor of FDI. With a weak evidence ‘beachhead effects of trade provisions’ seemed to be the second important driver and third was ‘tariff jumping effects of trade provisions’. ‘Beachhead’ effect happens when investment is executed in order to serve the markets of the others.

**Table 2. Main drivers of investments in PTAs**

<i>No effects</i>	<i>Tariff jumping effects of trade provisions</i>	<i>Beachhead effects of trade provisions</i>	<i>Non-trade provisions</i>
Andean Pact	SPARTECA	SPARTECA <sup>a</sup> US-Israel <sup>a</sup>	EFTA EU NAFTA MERCOSUR AFTA CER

<sup>a</sup> Only weak evidence for this characterisation.

Note: Main drivers of investments in PTAs. Adapted from “The Trade and Investment Effects of Preferential Trading Arrangements – Old and New Evidence” by Adams et al. 2003. Productivity Commission Staff Working Paper, Canberra, May. p. 94

PTAs can have an alternating impact on countries in the region especially when the regions are highly heterogeneous and include both developing and developed countries (UNCTAD 2009; Chen 2009). When transportation costs decrease as a result of integration, companies have more variety to choose where it places the production. If multinational companies transfer production into a more attractive location, for example due to lower production costs, the less attractive country may face declining FDI inflow (Chen, 2009). Although, UNCTAD (2009) states that the net effect of such reorganization on FDI is difficult to predict.

These findings indicate that we cannot assume a causal relationship between PTA and FDI. The evidence from the studies on this subject suggest a positive relationship, however, isolating the impact of PTA on FDI, and the FDI growth due to wide-ranging economic and technological forces is difficult and might cause varying results. Therefore, the next chapter reviews impact of previous similar agreements referable to CETA.

### 3.2. Review of previous similar agreements

This chapter will present the FDI trends resulting from similar free trade agreements as CETA, and analyze their comparability to CETA. The comparability depends on multiple factors, such as similarities and differences in country factors, previous FDI integration between the counterparts, and similarities in the FDI restrictions. Useful agreements should contain similar provisions as CETA and the participating countries should be at least somehow comparable with the EU and Canada. North

America Free Trade Agreement (NAFTA) and Free Trade Agreement between the U.S. and Australia (AUSFTA) were chosen as useful indicators to assess CETA's impact on FDI.

### 3.2.1. North America Free Trade Agreement

The North America Free Trade Agreement (NAFTA) is a trade agreement between the United States, Canada and Mexico taken into force in 1994. In addition to similar economic and social goals with CETA, NAFTA as well deleted 99% of the tariffs on traded goods, lowered barriers on FDI, and increased investor protection (Feils & Rahman, 2008). In addition, NAFTA includes a dispute settlement mechanism and similar intellectual property provisions. Free trade agreement between the counterparts was a natural follow up for their former integration and intimate location.

While the economic scope of NAFTA and CETA is somewhat different, NAFTA is still useful illustration of the reinforcement of such commercial relations. In the Kirkpatrick, et al. Sustainability Impact Assessment (2011) NAFTA is noted as an especially useful indicator if the FDI relationship between Canada and the U.S. is considered. Although, the relationship between Canada and the U.S. was already matured and integrated before NAFTA. The EU is not as integrated with Canada as Canada was with the U.S. before the agreement.

The FDI impacts between the U.S. and Canada was chosen to be addressed. Mexico's relevance in this analysis is questionable due to its developing nature. The comparability to neither Canada nor the EU is relevant. According to number of studies the FDI impact between the U.S. and Canada was positive (e.g. Globerman & Shapiro, 2002; Buckley et al., 2000; Kirkpatrick et al. 2011). Feils & Rahman (2008) and Waldkirch & Tekin-Koru (2010) found that the impact on FDI was positive, but ambiguous for individual member countries. According to Kirkpatrick et al. (2011) the overall impact of NAFTA was positive, but it is unclear how much resulted from the investment chapter.

### 3.2.2. Australia and the United States Free Trade Agreement

The best estimate for the impact of CETA is likely to be the results of the Free Trade Agreement between the U.S. and Australia (AUSFTA) signed in 2004. Similarly, as CETA AUSFTA raised the review threshold for investments from the U.S., improved intellectual property protection, and liberalized FDI restrictions, especially screening (Armstrong, 2015). Australia has negotiated several

FTAs but AUSFTA is the only which has significantly lowered barriers on foreign investments (Kirchner, 2012).

Similarities in restrictiveness can be found in the U.S. and the EU economies as well as in Australia's and Canada's economies, which makes AUSFTA a better baseline for analyzing CETA (Kirkpatrick et al., 2011). Australia is relatively high restricted as well as Canada, whereas EU and the U.S. have lower restrictions. While Australia is generally more restricted than most countries, it's however significantly less restricted than Canada. The previous integration can be seen similar as well if distance is considered. While the U.S. and Canada have a relatively mature relationship, neither of them has as far developed relationship with neither the EU nor Australia.

Relatively few analyses of the FDI impact of AUSFTA was found. According to Armstrong (2015) FDI flow from the U.S. to Australia has been rising from 2005 to 2012 but the share of total FDI has remained fairly steady during the time period. According to Kirchner (2012) liberalizing screening increased inward FDI to Australia, although Armstrong et al. (2015) claim that the effect of the preferential liberalization of investment screening on investment flows is hard to isolate. Armstrong et al. (2015) also criticizes Kirchner's analysis for the reason it couldn't provide an explanation why liberalization in screening increased FDI inflows.

#### **4. EU and Canada Integration and Investment Environments**

Bilateral relations between the European Union and Canada started in 1950s, both economic and political relationship have always been stable. In 1976 EU and Canada signed the Framework Agreement for Commercial and Economic Cooperation which was followed by the Declaration on Transatlantic Relations in 1990. Since 1976 Canada and EU have concluded multiple sectoral agreements and EU member states have bilateral agreements with Canada. Now the cooperation will deepen in economic and trade matters, but also in political and social actions. In addition to CETA, EU and Canada will be signing Strategic Partnership Agreement (SPA) which will enhance co-operation in such issues as international peace and security, counter-terrorism, human rights and nuclear non-proliferation, climate change, sustainable development, and innovation. (European Commission and Government of Canada, 2008)

## 4.1 Current integration

For long Canada and the EU have both been important trading partners to each other. Currently EU is the second important trading partner for Canada and for EU Canada is the 10th most important. Exports from Canada to EU in 2016 were €32,223 million and imports to EU were €29,075 (European Commission, 2017c). Both exports and imports have been generally steady for the last five years and imports have been slightly increasing. Tariffs between the EU and Canada for most goods are low, excluding tariffs for processed food which are set generally high (European Commission and Government of Canada, 2008). Services are a significant part of the trade in such areas as transport and travel services, and insurance and finance services. (European Commission, 2017a)

EU is Canada's second largest FDI provider with €248.8 billion stock value in 2015. The most important investment sector is affiliate sales which stands for selling the goods in a foreign country through the established production in the country. FDI towards EU in 2016 totaled €219.2 billion which was roughly 1/5 of Canadian direct investment abroad. FDI flow has been steadily increasing from 2007 until 2015 when Canadian FDI in Europe faced a decline.

Labor mobility between the EU and Canada is relatively efficient in both regions, but more restricted in Canada. As most countries Canada has limited labor mobility to temporary visits. Foreigners wanting to work in Canada can be accepted under Temporary Foreign Worker Program (TFWP) (Kirkpatrick, et al., 2011). Canadians have a relatively easy access to countries in the EU. Most of the countries welcome Canadian business people under Schengen acquis and some countries, such as UK and Ireland, decide arrival approval case by case basis (Kirkpatrick et al., 2011).

## 4.2. FDI restriction types in EU and Canada

Limiting foreign ownership particularly in key sectors, screening and approval procedures, constraints on foreign personnel and operational freedom, and other restrictions such as informal barriers, are formal ways to restrict foreign investments (Golub, 2003). This chapter reviews each of these briefly before comparing restrictions in the EU and Canada.

### *Equity restrictions*

The most common way to restrict foreign investments is limiting foreign ownership. Foreign ownership can, for example, be limited up to 50% for non-residents, or even completely prohibited in certain sectors (OECD, 2008). Generally high limitations in foreign ownership are used in service sector, including telecommunications, air and maritime transport, and finance (UNCTAD, 2009). These sectors are mostly protected due to national security and national sovereignty considerations. In comparison, manufacturing is the least restricted and often encouraged in multiple countries (Golub, 2003).

### *Screening*

Obligatory screening and approval procedures can include stipulations for foreign investments economic benefits for the host country, national interest tests, or pre-notification requirement for investors (Kalinova, 2010; Golub, 2003). The strictest requirements require investors to present evidence for providing net benefit for the host country, and lowest require a notification of a new investment.

### *Constraints on foreign personnel and operational freedom*

Constraints on foreign personnel and operational freedom often include stipulations for the amount of non-resident in the board of directors, the ability to either manage or to work in affiliates. Restraining can discourage foreign investments as it restricts company's freedom over their foreign agencies. The time foreign personnel can spend in the country might be restricted or even denied with duration of permissible work permits for expatriate executives. (Golub, 2003)

### *Other restrictions*

Other restrictions target operations of foreign investors. This category is considered the least important of the restriction types. Restrictions include establishment of branches, acquisition of land for business purposes, reciprocity clauses in particular sectors, and restrictions on profit or capital repatriation (Kalinova, 2010).

## 4.3. Comparison of the investment environments in the EU and Canada

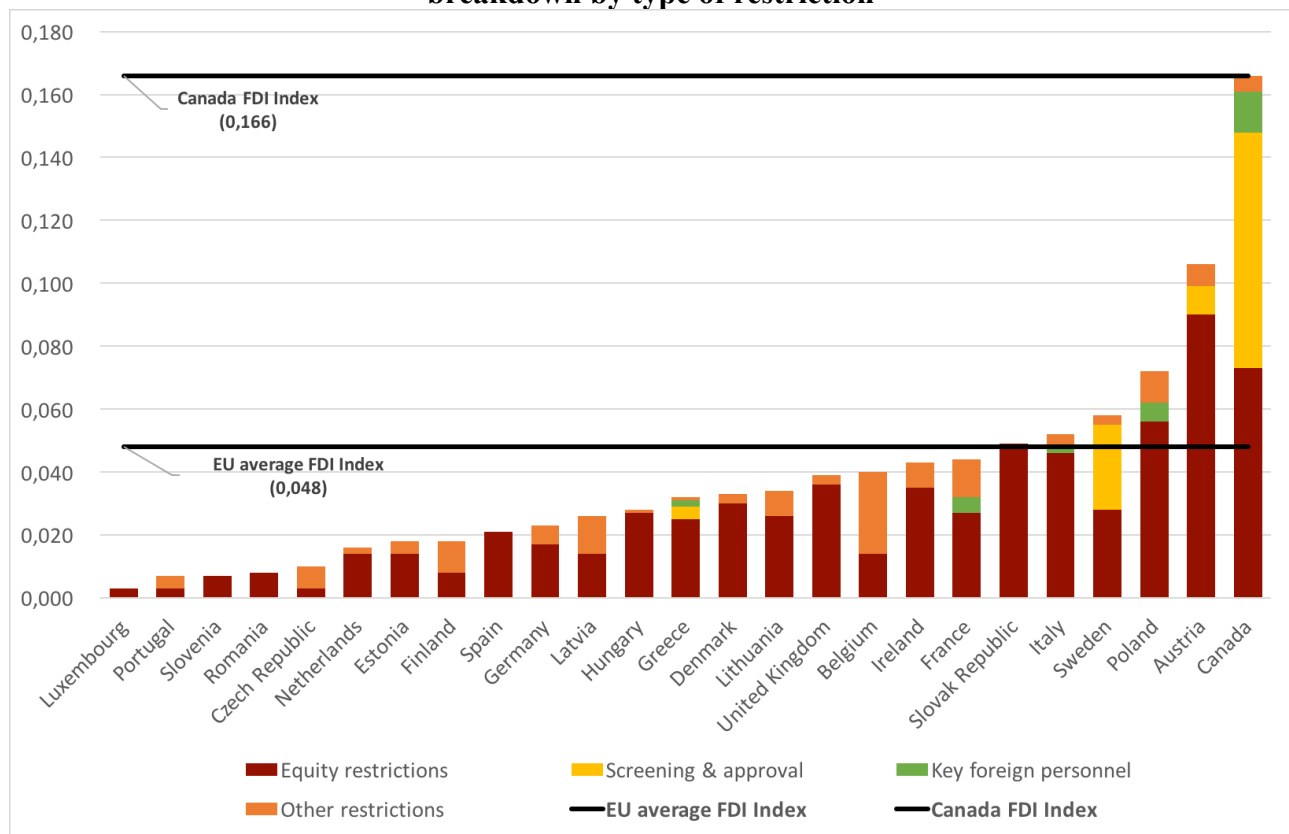
The investment environment in both Canada and the EU is governed the domestic and international rules to protect and decrease concerns of losing national sovereignty. The investment environment can be assessed with OECD's FDI Regulatory Restrictiveness Index (FDI Index) which uses four

categories to analyze the investment environment; foreign equity limits, screening and prior approval, restrictions on key foreign personnel/directors, and other restrictions (Kalinova, 2010). Categories are weighted by their significance, for example foreign equity limitation is more important than screening (Kirkpatrick et al., 2011). The FDI Index is not a perfect measure of investment environment however, it gives an overview of the attractiveness of country's investment climate considering barriers rising from rules set by the government.

The current FDI Index for Canada is 0.166 and for EU the average is 0.048 (0 = most open, 1 = most closed), which indicates that Canada's investment environment is more restricted than the EU's (OECD, 2017). Canada has significantly improved its investment climate from 2006 when FDI Index was 0.359, but has still notably high restrictions compared to the EU (Kirkpatrick et al., 2011).

From Chart 1 we can see that the most common restriction type for both EU and Canada is equity restrictions. The commonness is generally explained by national security concerns and protecting domestic industries from foreign competition.

**Chart 1. FDI Regulatory Restrictiveness Index in EU Countries and Canada, 2016, breakdown by type of restriction**



Source: Data from OECD, 2017

Note: Missing data from Bulgaria, Croatia, Cyprus, and Malta

Restrictions in the European Union are generally low however include some exceptions, e.g. Austria (see Chart 1). Austria is the highest restricted EU country and the equity restrictions are slightly higher than in Canada. EU countries do have common statutes but exceptions rise from the non-harmonized nature of EU's investment environment.

Canada is one of the highest restricted OECD country in terms of FDI and the investment environment is protected by multiple acts defining the sectoral limitations. The challenging investment targets for foreign investors are telecommunication, media, transport, air, and fisheries (see Table 2). Restrictions in telecommunication and media are common and can be understood by the desire to protect sovereignty. Most of the restrictions in telecoms, media and air limit the non-Canadian ownership of voting shares to a certain threshold (Riley, 2001).

Table 2 lists Regulatory Restrictiveness Indexes by sector and industry in the EU and Canada. Apart from maritime, and agriculture and forestry, all other sectors are more or less restricted in Canada than in the EU.

**Table 2. FDI Regulatory Restrictiveness Index by sector/industry, EU average & Canada, 2016**

(0 = most open, 1 = most closed)

<b>Sector/Industry</b>	<b>EU average</b>	<b>Canada</b>
Media	0,064	0,710
Telecoms	0,013	0,565
Financial Services	0,009	0,073
Business Services	0,051	0,100
Transport	0,135	0,267
Maritime	0,120	0,100
Air	0,272	0,600
Agriculture & Forestry	0,024	0,010
Fisheries	0,168	0,600
Manufacturing	0,002	0,100

Source: Data from OECD, 2017

Note: Missing data from Bulgaria, Croatia, Cyprus, and Malta

Financial service sectors play an important role in bilateral investment for both EU and Canada. Establishing is limited, but this concerns both domestic and foreign investors. In addition, Canada exercises an additional screening process for investments over \$1 billion CAD for WTO members



(Kirkpatrick et al., 2011). Investments crossing this threshold must present evidence that their investment will provide net benefit for Canada.

Business sector includes legal, accounting, tax, prep and bookkeeping, architectural, engineering, advertising, computer system design and other business services. The sector is already facing relatively low restrictions in both regions and doesn't leave much room for liberalization. Although, some sectors face stricter restrictions which gives more potential to CETA.

## **5. Comprehensive Economic and Trade Agreement**

CETA is a comprehensive agreement between European Union and Canada concerning trade and investments. CETA was originally introduced in 2009, accepted in 2014 and is yet to be entirely ratified and taken into practice. The provisional application of the agreement will start in September 2017, and the full ratification will be ready when all parliaments in member states have approved the agreement (European Commission, 2017a). The provisional application excludes specific concerns, such as investment protection, Investment Court System, and investment market access with regards to portfolio investment (European Commission, 2017a). These in their final form might be different.

CETA is the most ambitious agreement yet made and is in many means significant agreement for both the EU and Canada. CETA is EU's first comprehensive agreement made with a highly industrialized country and the first bilateral economic agreement to include Investment Court System (European Commission and Government of Canada, 2008). For Canada CETA is the most ambitious agreement but not the first of a kind, as Canada is a member of NAFTA.

CETA aims to increase growth, and job and business opportunities decreasing barriers in co-operation. The agreement will eliminate nearly all customs duties to zero by the end of the commissioning period, end limitations in access to public contracts, open-up services' market, provide unsurprising environment for investors, and help avoid illegal copying in EU innovations and traditional products (Cantemir, 2015). In addition, CETA is anticipated to create jobs, liberalize job movement, create new opportunities on both markets especially for small and medium-sized enterprises (SME), lower prices and offer greater variety of choices for customers (European Commission, 2016a).

According to Kirkpatrick et al. (2011) and European Commission (2017b) positive impact from CETA as a whole on foreign investments is expected, and it could be ‘notable’ but it is not likely to be significant. It is expected that the positive impact will be directed to specific sectors.

### 5.1. CETA’s impacts in a broad perspective

Resulting from the lack of empirical information, analysis of CETA’s potential impacts on FDI will be performed on grounds of the available information about CETA, links between previous PTAs and FDI, and theoretical framework. Consequences are difficult to predict since CETA together with the investment provisions and other commitments can have repealing impacts and no clear causal relationship can be assumed. Although, the provisional application excludes provisions on investment protection and dispute settlement system, these will be analyzed in this thesis in their current form, regardless of the exclusion from the provisional application.

Apart from the investment chapter CETA as a whole includes multiple commitments important for illustrating the impact on foreign investment flows. This chapter will introduce investment provisions and other potentially important commitments for FDI included in CETA such as trade, intellectual property rights, labor mobility, and investor protection, and analyze the potential impact on FDI. The impacts of the commitments are sometimes difficult to predict with unambiguous certainty.

Changes in the internal FDI distribution can be expected, especially in the EU. As discussed earlier, reducing FDI barriers in heterogeneous and integrated areas may have an asymmetric impact on the integrated bloc. EU is a relatively heterogeneous region as most of the countries are developed but some are still developing. Cultures, interests, and policies vary greatly as well. Multinational corporations can replace production from countries with high production costs to a more favorable country if it comes less costly to export within the integrated bloc.

#### 5.1.1. Services and investment

The measures defined in the investment chapter are set to expand market access between the parties, protect investors, and ensure non-discriminatory treatment, known also as national treatment (European Commission, 2016a). Non-discriminatory treatment grants equal treatment for both

domestic and foreign investors. Investment chapter promises to decrease barriers on FDI, such as foreign equity caps, screening, and performance requirements, allowing investors to transfer capital between the counterparts freely. Investment Court System (ICS), a new mechanism, is proposed to be set to alleviate the fair and quick processing of disputes between the state and foreign investors.

Instead of defining which sectors are liberalized, CETA includes a ‘negative list’, which lists reservations for measures to be excluded from the sectoral liberalization and no other restrictions will apply. According to European Commission (2016a) the content of these reservations relates to obligations on national treatment, Most-Favored-Nation treatment, market access, and performance requirements especially in the area of services and investments. These measures are listed in two annexes depending whether the Parties want to remain their right to change the restrictions.

The first, ‘Annex I’, includes existing measures and restrictions which the parties want to maintain concerning service providers and investors of the other side. Furthermore, European Commission (2016a) states that investors will benefit also of any future liberalization. While the measures in Annex I cannot be changed, ‘Annex II’ lists measures and restrictions which the parties want to maintain but as well reserves the right to adopt new more restrictive measures. (European Commission, 2016a)

Additional liberalization may be applied and especially Canada has agreed to a new liberalization in certain sectors, such as postal services, telecoms and maritime transport (European Commission, 2016a). Canada promised to maintain the current level of restrictions in certain financial services and not to make them more restrictive.

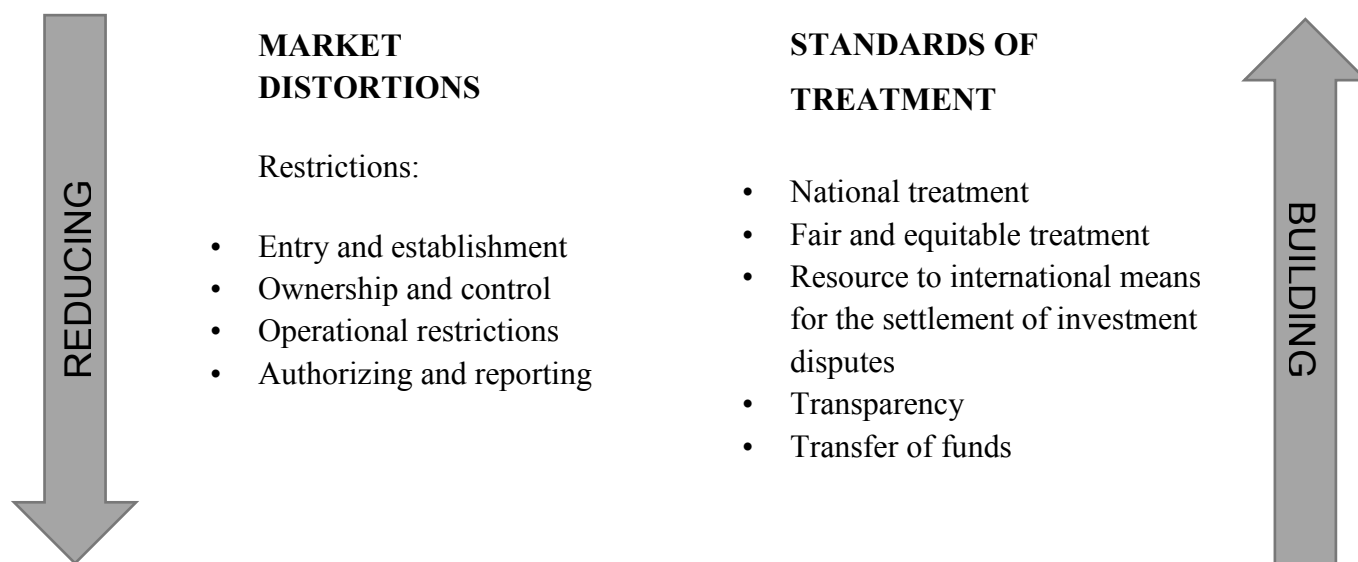
Screening restrictions will be reduced in Canada, facilitating foreign investments. The net benefit review threshold for the EU FDI in Canada will be raised from the current \$354 million CAD to \$1.5 billion CAD. Meaning that non-sensitive investments under \$1.5 billion will not be required to notify the Canadian Government and won’t be objected.

EU wanted to maintain flexibility in public services and included reservations concerning education, health, social services, public transport, and water supply in Annex II. Whereas, the level of liberalization in mining, energy, and environmental services, is now binding through Annex I.

### *Potential impact of liberalization*

Liberalization means decreasing or abolishing restrictions in entry and establishment, ownership and control, operational restrictions, and authorizing and reporting, but also building standards of treatment (see Figure 1) (UNCTAD, 1998). Liberalization can be seen as a FDI determinant since FDI cannot enter into a country without allowance. According to UNCTAD (1998) liberalization is needed and may encourage foreign investment however, it does not guarantee that FDI will occur. Kirkpatrick et al. (2011) agree that investment liberalization is a generally recognized attractor of investment and growth when combined with certain other policies e.g. investor protection, fair and equitable treatment, transparency, and a comprehensive legal framework.

**Figure 1. The liberalization of FDI policies**



According to Kirkpatrick et al. (2011) the first important step for FDI would be taken through liberalizing certain sectors. Liberalizing the sectoral FDI restrictions might have different magnitude to EU and Canada. Considering how low the current restrictions for foreign investments in the EU are, CETA may not reduce the level in any significant degree. Whereas, Canada is one of the highest restricted countries which indicates that CETA could offer possibilities in highly restricted sectors for foreign investors. This could be interpreted that CETA's effect on FDI flows will be more significant towards Canada than the EU.

Certain service sectors have a great potential to attract FDI flow under CETA, such as postal and telecom services. Kirkpatrick et al. (2011) states that the Canadian telecom sector has a large potential to grow under the provisions of CETA but claims that the concerns of compromising the Canadian

cultural objectives are disturbing the liberalization. However, the European Commission (2017b) services respond to Kirkpatrick et al. analysis and criticize the statement of compromising the cultural objectives and point out that the EU has fully legalized telecoms without any problems. Which leads one to ask why wouldn't Canada be able to do the same. Depending on the final level of liberalization in the telecom sector, the sector could have a lot of potential for further growth. As when compared to the other OECD countries, the Canadian telecom sector is currently less competitive, mainly due to high restrictions. Competition would widen the choice for customers and lower the overall costs. (Kirkpatrick et al., 2011)

Whereas, low restrictions in manufacturing and business sector will not leave much room for CETA to improve the FDI environment. Foreign investment in these sectors is not expected to increase considerably. Manufacturing is generally the largest target for foreign investments, which can be partly explained by significantly low restrictions in most of the countries. Low restrictions indicate that it's harder to attract more FDI to manufacturing.

#### 5.1.2. Trade

Tariffs for European and Canadian products will be cut by €400 million a year starting on the implementation day and the amount will be raised to €500 million a year until the end of the transitional period (European Commission, 2017a). 'Rule of origin' will define what products are qualified as 'European' and 'Canadian' to prevent third parties indirectly abusing the agreement. According to a prospective analysis conducted by the Canadian Parliamentary Budget Officer (PBO) (2016) the total GDP increase in Canada is estimated to be 0.16% and in EU 0.02% resulting from the price effects of the tariff reductions cascade through the economy via income and substitution effects.

#### *Potential impact of trade commitments on FDI*

The effect of trade on FDI flows is ambiguous. Theoretically trade openness can have two-way influences on FDI and trade can act as a complement or substitute for FDI. On the one hand, open cross-border trade is found to be positively related to investments (Kirchner, 2012; Adams et al., 2003). Decreasing barriers on goods will lower trade costs leading to changes in expenditures (Anderson et al., 2016). Eventually market size grows – a key determinant of FDI – and creates more incentives (Medvedev, 2011). In a foreign country companies can serve consumers straight, rather than through exporting. For companies, it might be better to invest in countries with similar factor

endowments if the benefit of proximity to consumers is larger than benefit of scale economy (Chen, 2009).

On the other hand, trade can become a more attractive choice than FDI, resulting in a decrease in FDI flows. Regarding to market-seeking or “tariff-jumping” motivated companies, primarily FDI would be expected to decrease because trade liberalization makes exporting from the home country more attractive option than foreign investment in order to serve the regional market (Adams et al., 2003).

However, the impact of trade openness is not as straightforward if companies have an efficiency-seeking approach and investment was originally undertaken to exploit assets. If target country’s comparative advantages create more benefit for multinational companies locating in a foreign country becomes more attractive. Company’s production process components require different intensities and companies often fragment the production process internationally to countries where the factor used in the value chain is abundant (Chen, 2009; Blomström & Kokko, 1997; Vetter, 2014). High labor endowment is a particular attractor of FDI especially in the case of labor sensitive industries (Chen, 2009).

### 5.1.3. Intellectual Property Rights

CETA will make intellectual property rights more consistent between the parties which will create more level playing field for companies in EU and Canada. Primarily the changes will be in Canadian IPR laws. Changes will consider copyrights, patents, protection of technological measures, and digital rights management (European Commission, 2016a). Canada has also promised to fight against the counterfeit trademark goods, pirated copyright goods, and counterfeit geographical indication goods (European Commission, 2016a).

#### *Potential impact of IPR commitments*

Many EU and Canadian products rely on innovation and creativity, and consequently intellectual property rights (IPR) play an important role in attracting FDI as poor IPR increases the chance of imitation and consequence in losses for investors. Intellectual property might be the key competitive advantage for companies and in the environment of poor IPR, theft can take away the advantage which was exclusively theirs (Haley, 2000). The importance of IPR varies across sectors and investment projects, for example R&D sector tends to prefer strong IPR (Javorcik, 2002).

More benefits have occurred in countries which have had weak property rights which a commissioned trade agreement has improved (Hallward-Driemeier, 2003). Hallward-Driemeier (2003) presents a common hypothesis that countries with weak property rights are more likely to appear as potential hosts for FDI if they improve their property rights and ensure the investors of stable environment. Countries must also assure their commitment to honoring these property rights to foreign investors as in some cases good property rights have been used only as a way to attract FDI and have then been neglected.

Kirkpatrick, et al. (2011) assume that IPR related decisions will benefit specific sectors and through that possibly increase FDI flows. Although Kirkpatrick, et al. (2011) didn't address the fact that Canada has autonomously improved the relevant IPR legislation and only minor part of changes will follow from CETA. The effect of IPR related commitments is not expected to be significant, since neither of the parties made any major changes in their legislation.

#### 5.1.4. Labor mobility

CETA has a temporary entry provision which will lower restrictions on labor mobility and enhance movement between the counterparts (European Commission, 2016a). Certain professionals and businesspeople, such as investors, intra-company transferees, technologists, and short-term business visitors have an easier access to temporary travel or relocate. Through temporary entry provision investors will have a greater certainty over their investments in EU and Canada. Intra-corporate transferees with their spouses and families are allowed to visit up to three years regardless of their sector of activity. Access of 'Contractual service suppliers' or 'independent professionals' will be increased to 12 months instead of the earlier 6 months. (European Commission, 2016a)

#### *Potential impact of labor mobility commitments*

Improving the labor mobility will most likely have a positive effect on FDI, nevertheless the impact will not be negative. A study made by the World Trade Organization (WTO) in 2005 found that 10% increase in temporary movement correlated to an 8% increase of FDI inflows and 7.1% of FDI outflows (as cited in Kirkpatrick et al., 2011). According to researches the impact will be clearer in non-service sectors than service sectors (Kirkpatrick, et al., 2011).

### 5.1.5 Investor protection

To ensure a functional foreign investment environment a dispute settlement mechanism is needed to protect investors, ensure a non-discriminatory treatment, and to avoid state-to-state conflicts. Non-discrimination stands for equal treatment of foreign investors and domestic investors. Even though it might seem self-evident that non-discrimination should be an essential part of investment policy the definition itself is sometimes problematic and ambiguous.

Canada is the most sued developed country in the world (Barlow, 2016). According to Barlow (2016) Canada has spent over €45 million defending itself in disputes occurred under NAFTA. A strong emphasis has been put on the dispute settlement claim by many authors and it's considered as a key objective in attracting the FDI inflow (e.g. Cingotti et al., 2016; Hallward-Driemeier, 2003; Barlow, 2016). The failure of investor protection systems inevitably leads to taxpayer's losses for legitimate public policy measures (Cingotti et al., 2016). The dispute settlement is yet under discussion and the public is currently strongly opposing the inclusion of the entire investor protection system in CETA as it in its current form fails to grant security for the state and its citizens.

Investor-state dispute settlement (ISDS) has been the common mechanism in the past negotiated agreements to solve disputes between governments and investors. ISDS defines on what terms foreign investors are allowed to bypass domestic courts to directly challenge government for measures that may negatively impact their investments. ISDS often brings corporations equal to governments in negotiations and leaves states and their populations without protection (Barlow, 2016). Corporations are able to sue governments directly without first pursuing action through country's legal system whenever new legislation negatively affects their profits. According to Barlow (2016) corporations are generally favored in these disputes and governments lose millions. ISDS has led to corporations abusing the system and taking actions against government measures whenever new law or practice affects their bottom line (Barlow, 2016). Hallward-Driemeier (2003) suggests that some investors might favor the legal systems favorability over economic reasons if there is a chance for successful litigation against the host government and where the investor protection mechanism is functioning.

ISDS has gained major public opposition which has followed up to replacing ISDS with Investment Court System (ICS) in CETA. Investment Court System is a proposal of a new independent mechanism which consists of permanent tribunal and an appeal tribunal (European Commission, 2016b). According to the European Commission (2016b) the standard treatment of investors and



investments is precisely introduced and doesn't leave discretion to the members of the tribunal. ICS will be a transparent and fair dispute settlement mechanism without ambiguities. The system is supposed to prevent egregious attacks made by investors towards government, which have occurred under ISDS, and reassure the public that public policy making wouldn't be affected negatively. European Commission (2016b) states that ICS will remove the flaws which made the previous dispute settlement system open to abuses.

CETA promises to fully preserve EU's and Canada's ability to right to regulate however, stakeholders accuse its poorly definition and possible openness for interpretation. 'Right to regulate' is defined as country's ability to adopt and apply their own laws and regulations. Countries must have right to regulate its laws and regulations without the fear of getting sued by investors who accuse a new law negatively impacting their investment. Right to regulate has to be well defined for the sake of both parties, as investors must also be aware of their rights concerning government's right to regulate.

Indeed, ICS seems to have improved the investor protection and clarified the terms but yet fails to create a functioning system. It grants rights to investors but fails to protect the government and public policy making from exploitation. Terms, such as government's "right to regulate", are claimed to be poorly defined and are open to interpretation leading to possible abuse (Cingotti et al., 2016). The proposal of the dispute settlement system has been criticized and seems falls short on addressing core concerns. ICS is claimed to be ISDS under another name (Cingotti et al., 2016).

A research made by Cingotti et al. (2016) test whether cases failed under ISDS would pass under the anticipated ICS and whether ICS would represent a remarkable change from the current iniquities of ISDS arbitration. The results were disappointing as the analysis shows that all the tested cases could still be launched allowing companies to challenge the government. Which supports the claim of ICS being the same kind of failure as ISDS.

#### *Potential impact of Investment Court System on FDI*

The court systems in Canada and the EU already include high protection for both domestic and foreign investors. However, EU has never committed in any dispute settlement mechanism and the proposed ICS system could open possibilities for the EU investors to sue Canada, but also might expose EU for abuse as well (Kirkpatrick et al., 2011).

Kirkpatrick et al (2011) doubts that the mechanism wouldn't create a net sustainability benefit due to the conflicting costs and benefits, but also states that without enforcement of such mechanism there is no reason to believe that the Investment chapter would create the same positive economic impacts as expected. The current ICS proposal does not maximize sustainable economic benefits, however if EU and Canada manage to improve ICS in significant matter and make the legal investment environment favorable it might support the other provisions to attract investors.

## 5.2. Potential positive effects of CETA based on the analysis of NAFTA and AUSFTA

Most of the previous literature adduced positive FDI impact from both NAFTA and AUSFTA. This chapter briefly explains why CETA could have a positive impact on the FDI flows if the consequences are similar as NAFTA and AUSFTA had.

NAFTA had a positive impact on the FDI flows between the U.S. and Canada. Since the relationship between the EU and Canada is not as integrated as Canada's relationship was with the U.S. before commissioning of NAFTA, CETA could have potential to attract more FDI. According to Kirkpatrick et al. (2011) the effect between Canada and the EU might have a larger scale due to the lower level of integration. The explanation for this potential impact is that before NAFTA, the U.S. and Canada had executed FDI actions on a larger scale and didn't leave as much room for FDI actions as a less mature relationship would have. Canada and the EU have an advanced FDI relationship, but the number of new opportunities is larger.

Analysis of AUSFTA adduced two potential reasons why FDI flows could increase. Both are based on Canada's strict FDI environment and the large scale of opportunities, which CETA could offer by the FDI liberalization. Both Canada and Australia are highly restricted in the FDI area, however Australia is significantly less restricted than Canada. Firstly, if the impact of CETA is estimated based on the comparison of the restriction environments in Australia and Canada, CETA has more potential to encourage more FDI in Canada than AUSFTA did in Australia. Secondly, if liberalizing screening was one of the reasons why inward FDI flow towards Australia increased, it could indicate that Canada would receive FDI inflow for the same reason.

The analysis based on NAFTA and AUSFTA implicates at least two reasons why FDI flows could increase in the case of Canada and the EU; lower level of integration between Canada and the EU,

and strict FDI environment in Canada and Australia. The analysis suggests that, presumably CETA could increase FDI between the counterparts on a larger scale than AUSFTA, and the same amount or more as NAFTA.

## **6. Conclusion**

The aim of this thesis was to estimate the potential impacts on Foreign Direct Investment flows rising from the commitments made in the EU – Canada Comprehensive Economic and Trade Agreement. Kirkpatrick et al. (2011) and European Commission (2017b) estimated that a positive impact from CETA as a whole on FDI flows is expected, and it could be ‘notable’ but it is not likely to be significant. This estimation is aligned with the analysis of this thesis. As we are talking about two relatively developed countries it is logic that these countries attract significantly new FDI as much as a distinctly developing country would.

The impact was approached by analyzing the link between FDI and PTA, analyzing NAFTA and AUSFTA, and the current states of EU and Canada's investment climates and the potential for those to be improved under CETA. The FDI impact is difficult to isolate from growth resulting from other sources which makes the link between FDI and PTA ambiguous. Although, several authors noted a positive relationship between FDI and PTA (e.g. Medvedev, 2011; Büthe & Milner, 2008; Lederman et al, 2005). NAFTA and AUSFTA based analysis supported some positive consequences of CETA in FDI flows, and the analysis of the investment climates offered several reasons to believe CETA has a potential to increase the FDI flows.

Non-trade provisions, such as FDI liberalization, were found to be the most important driver of FDI flows and it could be expected to be an important determinant in CETA. By reducing market distortions and building standards of treatment CETA has potential to increase FDI flows. High restrictions could indicate that CETA might have high potential to enhance the openness of investment environment. Whereas the EU doesn't have as much possibilities to attract FDI by liberalizing restrictions. The impact will most likely not be significant in the EU, considering its current relatively attractive investment environment and already low restrictions.

The analysis brought up a few reasons which could slow down the potential FDI growth or even cause a decrease in foreign investment flows. It cannot be assumed that liberalizing FDI restrictions will

inevitably increase investments. Firstly, when both FDI restrictions, and tariff and non-tariff barriers for goods decrease multinational corporations have more freedom to choose whether to export or invest (Motta and Norman, 1993). If the reduction of trade barriers has a larger impact on exporting making it more productive than investing then exporting might become more profitable for companies. Consequently, FDI flows might decrease.

Secondly, for the same reason, a heterogeneous and integrated bloc can face an internal distribution in FDI flows after commissioning a PTA. Lower transaction costs offer wider choice of countries for investors to place their investment. Consequently, certain countries may face a decrease in FDI flows. This might be the case especially for the EU where countries are relatively heterogeneous.

Thirdly, the ongoing debate concerning the dispute settlement might decelerate the increase in foreign investment flows. Currently the Investment Court System proposal is left outside of the provisional application and will be under further consideration. If ICS is improved, the dispute system can offer more incentives for investors to enter into FDI.

Despite these obstacles, this thesis introduced several reasons to believe that CETA has a high potential to increase FDI flows between these low risk countries in certain sectors. Currently CETA is being ratified by the governments of Canada and the EU and its member states. The commissioning will start by provisional application and whether the FDI flows eventually increase on a 'notable' scale remains to be seen.

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